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Delaware Decisions Complicate Sales of Companies

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The board of directors of a venturebacked company often includes directors elected by venture capital holders of preferred stock. When there have been several rounds of preferred stock investments, those directors are likely to constitute a majority of the board. This common situation would appear to give the directors elected by the venture capital investors the ability to approve a saleof a company at the board level, even if the aggregate liquidation preference of the preferred stock would consume the entire proceeds of the sale.

However, for those companies incorporated in Delaware, two recent decisionsof the Delaware Chancery Court imply that the board decision to sell the company, in a situation where the sale proceeds will be used to satisfy the preferred stockholders' liquidation preferences and little or nothing will be paid to the common stockholders, could be evaluated under the "entire fairness" standard rather than the much more comforting "business judgment" rule. To date, there is no developed consensus regarding an effective approach for avoiding or easily defeating claims by common stockholders in this scenario.

In a 2009 Chancery Court case, *In re Trados Incorporated Shareholder Litigation*, the board of directors approved a merger in which the preferred stockholders received a portion of their contractual liquidation preference and no consideration remained for the common stockholders. The common stockholder plaintiff alleged that the company was a viable business and that the common stockholders could have received consideration in a future transaction had the merger not occurred and the company been permitted to continue.

The *Trados* court declined to dismiss the complaint because the plaintiff had alleged that a majority of the directors were designated by, and had economic ties with, the preferred stockholders and were unable to exercise independent and disinterested business judgment in deciding whether to approve the sale transaction.

The significance of the *Trados* decision to investors in preferred stock, such as venture capitalists, is that their designees to the board of directors may not be considered independent and disinterested in making a determination to sell the company particularly where the preferred stockholders will receive all of the transaction consideration and it is possible that the common stockholders would receive some consideration if the company were permitted to continue and pursue an alternate liquidity event at a future date.

The time and cost of defending these claims may be a serious deterrent to any potential buyer that may not want to take on the potential legal fees, much less potential ultimate liability of such litigation. Accordingly, the *Trados* decision may not just make things more difficult legally, it can also interfere with the transaction opportunity and economics of a potential saleof the company.

For a venture-backed company with the typical board composition, the *Trados* decision means that a sale where all or substantially all of the proceeds go to the preferred stockholders may be viewed as a "con_ict of interest" transaction. Approval of the transaction by disinterested directors, a committee consisting of disinterested directors, or the independent stockholders may be effective to restore the more lenient "business judgment rule" protection for the board decision, or at least shift the burden of proof to those attacking the transaction. However, while venture capital investors can seek the vote of the disinterested directors or stockholders, if the common stockholders will receive no or minimal proceeds in the sale transaction and have no downside risk from continuing the company, the directors who are elected by the common stockholders may choose not to approve such a transaction.

The difficulty of obtaining the vote of "independent" directors in favor of a transaction that provides little or no consideration for the common stock is exacerbated by another recent Delaware Chancery

Court decision, *LC Capital Master Fund Ltd. v. James*.

In *LC Capital*, the company's charter was drafted in an unusual manner so that the liquidation preferences of the preferred stock did not apply in a merger. Pointing to economic rights under the charter that were held by the preferred shares outside the merger context, the preferred stockholders argued that the board of directors had a fiduciary duty, rather than a contractual obligation under the charter, to allocate more of the merger consideration to the preferred stockholders. The court held that where contractual rights of the preferred stockholders in a merger are defined in the charter, and the board fully satisfies its duties to the preferred stockholders by honoring those contractual rights, the board owes the preferred stockholders no duty to reallocate merger consideration to benefit the preferred stockholders at the expense of the common stockholders.

At first glance, *LC Capital* may not seem troubling in the normal situation where the charter provisions will assure the preferred stockholders liquidation preferences in a merger transaction. However, the court recognized the duty of directors to pursue the best interests of the company and the common stockholders, if that can be done faithfully with the contractual rights of the preferred stockholders. The court further explained that once the contractual rights of the preferred stockholders are honored, the board's fiduciary duties to them are fully satisfied and any fiduciary duties with respect to the matter are owed solely to the common stockholders. This holding arguably provides a basis for directors unaffiliated with the preferred stockholders to vote against a transaction like the one illustrated in the first paragraph, where the contractual rights of the preferred stockholders do not dictate a sale and the common stockholders will receive little or nothing in the sale transaction.

Coupled with the *Trados* decision, *LC Capital* raises questions about how to insulate from challenge a sale where the common stockholders receive minimal or no proceeds unless the company is on the verge of bankruptcy. Barring harm to the enterprise from doing so, *LC Capital* may be used by common stockholders to contend that the independent directors may be obligated to try to keep the company alive in hopes that at some point, there will be a transaction that provides proceeds to the common stockholders.

In short, common stockholders will argue that the *Trados* and *LC Capital Master Fund* decisions stand for the principle that, where the company's charter expressly defines the rights of the preferred stock, the board is obligated only to fulfill those rights to the extent they are triggered, and its fiduciary duties with respect to discretionary matters run solely to the common stockholders.

There are a number of approaches venture capital investors may employ to avoid a situation in which the board's vote would be subject to common stockholder claims based on *Trados* and *LC Capital*. These approaches include adding independent directors to the board, making the preferred stock redeemable if certain milestones are not achieved and using contractual dragalong provisions that force the common stockholders to vote in favor of the sale transaction. The most viable approach may be to provide in the company's corporate charter (called the certificate of incorporation under Delaware law) that the company will be sold at the election of the preferred stockholders in the event that specific economic or other milestones are not achieved. To be effective, the investors would be well-advised to negotiate these provisions of the charter in connection with their investment and to make sure that the charter provisions are approved by the holders of the majority of the common stock. With these charter provisions in place, the board members would likely be seen by a court as merely fulfilling their contractual duties under the charter as opposed to exercising a discretionary decision to which their fiduciary duties would apply.

Finally, although the measures the board employs in the sale process may not solve the issues raised by these two cases, a thorough sale process may improve a court's overall view of the board's decision to sell the company. Best or better practices would include ascertaining whether alternate sources of funding are available, forming of a committee of independent directors to supervise the sale process, obtaining a fairness opinion, and possibly conditioning the sale on the approval of the disinterested common stockholders.

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